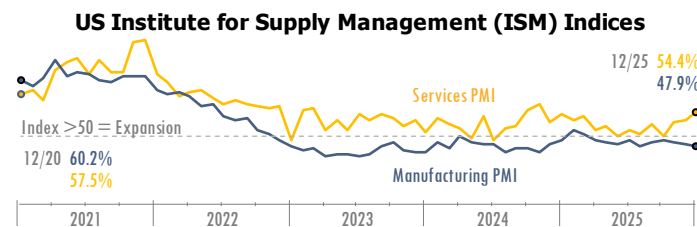
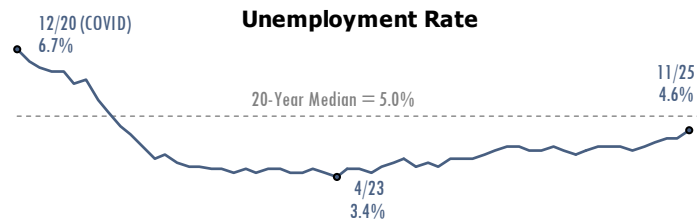
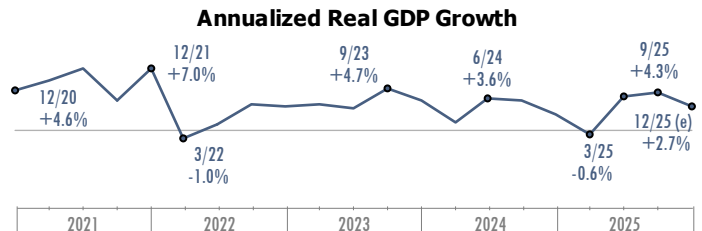


# MARKET Recap

## The US Economy: “Productive Debates on Productivity”

The US economy continued to post solid growth through the third quarter, and appears to be on track for a robust Q4. GDP grew at an annualized 4.3% pace in Q3, driven by accelerating consumer spending and upturns in exports and government spending. There are caveats of course; one important note is that data collection was impacted by the October/November government shutdown, so one might expect larger than normal subsequent revisions. Also, consumer spending was led by healthcare services and prescription drugs, not exactly categories of choice for consumers. That said, the aggregate economy performed surprisingly well in 2025 considering the bleak outlook following “Liberation Day.”



Inflation remained contained, while unemployment edged up slightly; neither data point lit a clear path. Throughout the post-COVID period (roughly since 2022) economic growth has been strong, yet unemployment has crept upward. Increased labor productivity, and total factor productivity, is often cited as the underlying driver.

Productivity is hard to meaningfully measure, and metrics tend to lag the current economy significantly, but an ongoing body of work by the San Francisco Fed provides interesting insight into the issue. Their measurement of total factor productivity (the ratio of economic output to inputs including labor and capital) seeks to isolate the amount of productivity gain or loss over long time periods due to exogenous forces like technological advancement. Productivity growth has accelerated significantly in recent years, roughly to levels experienced in the 2000’s decade prior to the Great Financial Crisis.

Pundits are quick to credit AI. Although given the lagged nature of the measurement, we believe it is likely due as much to technology adoption forced on organizations by the COVID pandemic (e.g., electronic meetings instead of travel).

Research from the Chicago Fed shows that recent productivity advancements have not been shared equally across sectors. Service industries, particularly technology, finance, and healthcare, have benefited more than manufacturers. Staff reductions have also been concentrated in these industries, whereas manufacturers continue to struggle to maintain talent levels. Many employers have made a bet that AI-related productivity gains will materialize into earnings, hence the anticipatory layoffs. Equity investors have already reaped the gains, and will likely suffer mightily if AI does not come through.

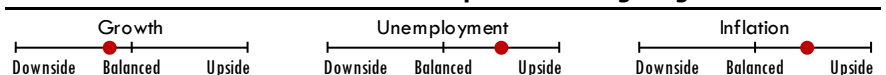
If productivity does drive long-term growth, the long-term inflation-neutral policy interest rate may also be higher. When asked at the December meeting press conference, Chairman Powell agreed, but quickly noted that many other factors drive the neutral rate. This makes sense because employment losses due to productivity cannot be offset by lower rates without risking inflation. Rather, displaced workers need to be retrained and, possibly, re-located to remain relevant. Rather than take on this challenge, the Administration seems focused on low rates as a solution.

### 12/25 Survey of Fed Board Members & Bank Presidents

	Median				Range			
	2025	2026	2027	Longer Run	2025	2026	2027	Longer Run
Change in Real GDP	1.7 ↑	2.3 ↑	2.0	1.8	1.5-2.0	2.0-2.6	1.8-2.6	1.7-2.5
Unemployment	4.5	4.4	4.2 ↓	4.2	4.4-4.6	4.3-4.6	4.0-4.5	3.8-4.5
PCE Inflation	2.9 ↓	2.4 ↓	2.1	2.0	2.7-2.9	2.2-2.7	2.0-2.3	2.0
Fed Funds Rate	3.6	3.4	3.1	3.0	3.4-3.9	2.1-3.9	2.4-3.9	2.6-3.9

Arrows = change from September

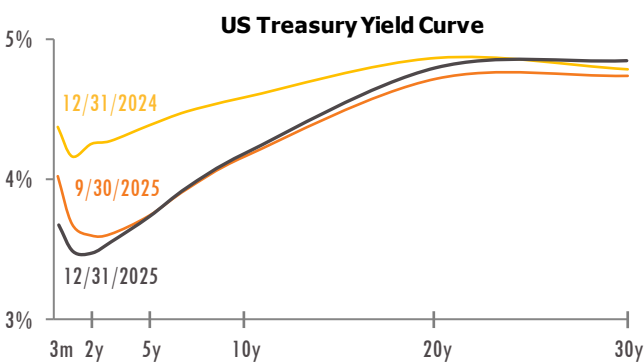
### Diffusion Index of Participant Risk Weightings



## The US Bond Market

US bond investors enjoyed another quarter of relative calm. Contrary to the volatility seen earlier in the year, yields from the 5-year through the 10-year maturities were almost unchanged for the quarter, reflecting a balance between moderating inflation data and surprisingly resilient economic activity.

The yield curve experienced a modest amount of steepening, primarily driven by a decline in short-term rates as the market aligned with the Federal Reserve's easing path. This shift was measured, as the 2-year yield drifted lower in response to policy adjustments while longer-dated maturities held firm, suggesting that investors are pricing in a stable outlook for 2026.



Versus one year ago, a more significant story is visible. The 10-year yield remained anchored as shorter-term rates adjusted to the Fed's more relaxed monetary policy. This re-steepening marks a critical transition in the market cycle, often referred to as the "restoration of the term premium." For the banking and lending sectors, this is a welcome development; a positively sloped curve supports net interest margins, potentially thawing the credit freeze that has constrained the real economy for much of the year. However, historical precedent suggests caution: a rapid steepening from an inverted state has frequently preceded the onset of a recession, as the bond market aggressively discounts the central bank's pivot to emergency accommodation. Whether this shift signals a successful "soft landing" or a defensive crouch remains the key debate for 2026.

Federal Reserve policymakers proceeded as anticipated, delivering additional rate reductions to support the labor market while maintaining a watchful eye on price stability. Following the initial cut in September, the Federal Open Market Committee announced consecutive 25-basis point reductions at both the October and December meetings. These moves were widely telegraphed and met market expectations, reinforcing the central bank's commitment to normalizing the policy rate as inflation pressures from earlier tariff implementations began to subside. The accompanying statement remained balanced, acknowledging the softening in payroll data noted in the third quarter but refraining from signaling an aggressive acceleration of the easing cycle.

US Bond Indices - Total Returns		
Bloomberg Idx	4Q25	2025
Aggregate	1.10%	7.30%
Short Gov't	1.08%	4.57%
Interm. Gov't	1.15%	6.50%
Long Gov't	-0.04%	5.61%
TIPS	0.13%	7.01%
Municipal	1.56%	4.25%
Interm. Credit	1.27%	7.88%
Long Credit	0.00%	7.77%
High Yield	1.31%	8.62%
Leveraged Loan	1.08%	5.51%
MBS	1.71%	8.58%

anced, acknowledging the softening in payroll data noted in the third quarter but refraining from signaling an aggressive acceleration of the easing cycle.

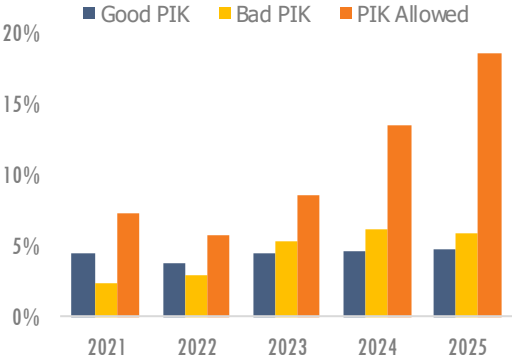
The major US bond sectors posted positive returns neatly clustered around 1.00% to 1.50%, with the exception of long-term debt and TIPS. Investment grade credit spreads remained near historical lows. High yield spreads were more volatile, widening out about 40 bps in the second week of October before reverting and then repeating this roundtrip in November. The first spike in spreads occurred on news of rising defaults in private credit markets. This sparked contagion fears that briefly pushed public spreads wider. November's softening in spreads tracked with a softer-than-expected payroll report that reignited recession anxieties. In both instances, the widening proved transient as opportunistic buyers took advantage of the temporary weakness, emboldened by the assurance of incoming rate cuts. Quarter-over-quarter, high yield spreads were nearly unchanged.

Corporate bond issuance followed seasonal patterns, with a flurry of activity in October and early November before tapering off in December. Issuers capitalized on the stability in rates to refinance existing debt, but net new supply was manageable.

Private credit markets continued to show signs of stress, though defaults and payment-in-kind (PIK) elections remained concentrated among smaller borrowers (EBITDA under \$50mm), validating the thesis that higher-for-longer rates had disproportionately impacted the lower end of the middle market.

A PIK amendment can be interpreted as a critical distress signal. Under this arrangement, a borrower pays interest with additional debt rather than cash, sidestepping liquidity issues and compounding leverage. When a PIK is incorporated at issuance, it can be due to the lender's confidence in the credit. However, when it is done later as an amendment, often it is a measure of last resort to avoid a technical default. This has created a "shadow default" dynamic that is largely invisible in headline metrics and acutely concentrated in the lower middle market, where some estimates show PIKs nearing 20% of outstanding loans.

Private Credit Middle Market PIK Prevalence



Source: TCW

## The US Stock Market

While not reaching the heights achieved in Q2 and Q3, the US stock market ended 2025 with another positive quarter. Full-year returns were double-digit for most major benchmark indices, making 2025 the third year in a row the S&P 500, the NASDAQ and the DJIA achieved this feat. Drivers for the quarter included continued easing by the Federal Reserve offset by a slow-down in AI enthusiasm. While the market broadened in Q4, the AI trade was the primary engine for full-year market performance.

US Stock Indices - Total Returns					
<u>Largecaps</u>	<u>4Q25</u>	<u>2025</u>	<u>Midcaps</u>	<u>4Q25</u>	<u>2025</u>
S&P 500	2.66%	17.88%	S&P Midcap 400	1.64%	7.50%
Russell 1000	2.41%	17.37%	Russell Midcap	0.16%	10.60%
Growth	1.12%	18.56%	Growth	-3.70%	8.66%
Value	3.81%	15.91%	Value	1.42%	11.05%
<u>Broad Markets</u>			<u>Smallcaps</u>		
S&P 1500	2.58%	17.02%	S&P Smallcap 600	1.70%	6.02%
Russell 3000	2.40%	17.15%	Russell 2000	2.19%	12.81%
Growth	1.14%	18.15%	Growth	1.22%	13.01%
Value	3.78%	15.71%	Value	3.26%	12.59%

4Q Total Returns	
<b>Mag 7</b>	
Alphabet (CI A)	28.8%
Apple Inc	6.9%
Amazon.com	5.1%
Tesla	1.1%
NVIDIA Corp	0.0%
Microsoft	-6.5%
Meta Platforms	-10.0%
<b>DrugMakers</b>	
Eli Lilly and Co	41.1%
Merck & Co	26.4%
Roche Holding AG	25.1%
Bristol-Myers Squibb	21.0%
AstraZeneca Plc	17.4%
Amgen	16.8%
GSK Plc	14.6%
Johnson & Johnson	12.3%
Gilead Sciences	11.3%
Novartis AG	7.5%
Sanofi SA	6.0%

Value outperformed growth for the quarter across all market caps, but only in midcaps did that occur for the year as a whole. As noted in our last issue, this midcap value anomaly has been fueled by outsized performance in telecom, traditionally associated with value investing. Companies in the sector have been benefitting from continued expansion of 5G networks, demand for data center capacity, and the pivot by investors to AI infrastructure. A notable example has been bandwidth technologies and services provider Viasat (VSAT), which returned 17.6% in Q4 and 304.9% for the full year. Fiber optic network provider Lumen Technologies (LUMN) returned 27.0% for the quarter and 46.3% for the year.

Across sectors, healthcare stood out for the quarter. Favorable drug-pricing agreements between major pharmaceutical companies and the Trump administration propelled the sector to a Q4 return more than 10% higher than 8 of the other 10 sectors. In these deals, the companies agreed to cut Medicaid drug prices and offer "massive discounts" through a federal website to customers paying cash. The deals are expected to advance direct-to-consumer (DTC) prescription drug sales, a relatively new channel to the US healthcare system.

By circumventing pharmacy benefit managers, who get rebates from sales through traditional channels, DTC sales can allow drug companies to maintain their net pricing

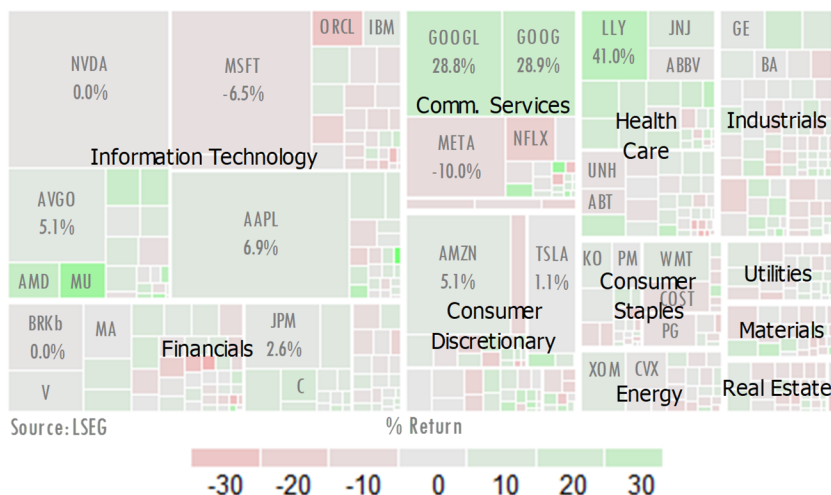
while still charging less for products. The lower cost benefit, however, will likely be limited to uninsured patients as those with insurance will still pay less by using their benefits at a pharmacy. In return, the companies will receive 3-year exemptions from sector-specific tariffs. Success was not limited to drugmakers, though. Health services companies Cardinal Health and CVS Health were rewarded for steps they took to make their businesses more profitable.

Quarterly returns across the Magnificent 7 varied dramatically, from 28.8% for Alphabet to -10.0% for Meta Platforms. The stars aligned for Google's parent as it benefitted from the launch and rapid adoption of its Gemini 3 AI platform, the November disclosure of Berkshire Hathaway's \$4.3 billion stake in the company, and the clearing of legal headwinds from its antitrust case. Meta suffered from a shake-up that led to the departure of Yann LeCun, leader of Meta's AI research efforts for the past 10+ years, to create his own startup. While over half the Mag 7 underperformed the broader market, this did little to diminish the cohort's US stock market dominance.

At year-end, the estimated Q4 earnings growth rate for S&P 500 companies was 8.3% year-over-year. If this rate materializes, it will make the tenth consecutive quarter of year-over-year earnings growth. The projected earnings growth rate for 2025 is 12.3%, which is lower than expected at the beginning of the year by 1.9% [FactSet].

S&P 500 Sector Total Returns		
	4Q25	2025
Health Care	11.68%	14.60%
Comm Services	7.26%	33.55%
Financials	2.02%	15.02%
Energy	1.53%	8.68%
Info Tech	1.42%	24.04%
Materials	1.12%	10.54%
Industrials	0.88%	19.42%
Consumer Discr	0.71%	6.04%
Consumer Stpls	0.01%	3.90%
Utilities	-1.40%	16.04%
Real Estate	-2.86%	3.15%

4Q 2025 Returns in S&P 500 Companies



International Markets

Global markets continued a streak of solid performance despite trade tensions and policy divergence. Developed European markets rose on a strengthening euro, easing inflation and a more accommodative policy stance. Emerging markets performance remained regionally mixed, with Latin America generally outperforming its developed peers, supported by strong capital flows and stabilizing inflation. China lagged.

Unhedged Foreign Markets Indices - Total Returns					
MSCI Stocks	4Q25	2025	Bloomberg Bonds	4Q25	2025
ACWI ex-US	5.05%	32.39%	Global Aggregate	0.24%	8.17%
EAFE (Developed)	4.86%	31.22%	Pan-Euro	0.65%	14.89%
Emerging Markets	4.73%	33.57%	Asian-Pacific	-2.24%	1.39%
Europe	6.20%	35.41%	Eurodollar	1.15%	7.24%
Japan	3.23%	24.60%	Other Currencies	4.66%	28.64%
China	-7.38%	31.17%			
Latin America	8.20%	54.81%			

Forecasts from The Conference Board suggest a global economic slowdown in 2026, with growth in the US and other major economies impacted by inflation, tighter monetary policy, and tariff knock-on effects. Global GDP growth is expected to ease in 2026 coming in around 2.9% before rebounding in 2027. While the global economy may be moving toward recessionary territory, a global recession is not expected.

**Asia**  
The MSCI China Index experienced a bifurcated year, concluding with a strong 31.2% YTD return. Leading into the final quarter, the index had seen a significant rally, driven particularly by the technology, hardware, semiconductors, and industrials sectors, which benefited in the first half of 2025 from the proliferation of artificial intelligence (AI). However, the fourth quarter saw a short-term pullback, resulting in a quarterly return of -7.4%. Economic data suggested the broader economy remained fragile. Indicators of anemic domestic consumption, such as the persistent weakness in the Consumer Price Index and periods of deflation, contributed to this market caution.

China's Economy			
Y/Y Statistics	Sept.	Oct.	Nov.
Manufacturing PMI	49.8%	49.0%	49.2%
Non-Manufacturing PMI	50.0%	50.1%	49.5%
Industrial Production	6.5%	4.9%	4.8%
Unemployment	5.2%	5.1%	5.1%
Producer Price Index	-2.3%	-2.1%	-2.2%
Consumer Price Index	-3.1%	-2.7%	-2.5%
Retail Sales	3.0%	2.9%	1.3%
Exports	8.3%	-1.1%	5.9%
Imports	7.4%	1.0%	1.9%

Source: National Bureau of Statistics of China

China's economic expansion throughout 2025 was fundamentally driven by resilient exports, creating a structural imbalance. The country reported a record trade surplus, topping \$1 trillion for the first 11 months of the year and underscoring its dominance in global manufacturing despite the impact of US tariffs. Export growth, up 5.9% year-over-year through November, defied expectations of a global slowdown. Rising shipments to Asia, Europe, Latin America, and Africa offset the hit from US levies. Having built their businesses around low trade barriers, this success suggests Chinese companies adapted and are now rebounding in diversified markets.

Despite the strength in exports and industrial production, the economy battled internal weakness, competition, and overcapacity, which pushed down prices,

profits, and incomes. Producer prices remained in negative territory. Retail sales slowed for the sixth consecutive month, highlighting persistent weak household demand. However, the surveyed urban unemployment rate held steady at 5.1% in November. As a result, economic momentum decelerated to its slowest pace in a year as gross domestic product expanded 4.8% in the third quarter of 2025, down from 5.3% growth in the second quarter.

Japan's economy contracted 0.4% in Q3, partly driven by exports falling 4.5% amid US trade tariffs. However, the BoJ raised its policy rate to 0.75% in December, the highest in 30 years, to contain persistent inflation driven by the weak yen. Wage negotiations delivered strong gains supporting consumption and making inflation more durable. Meeting minutes reflected that board members see further rate hikes ahead.

The MSCI Japan Index rose 3.2% in Q4 and nearly 25% for the year. Japanese equity markets were boosted by the "Takaichi Trade" - buying Japanese equities and selling yen - with expectations of aggressive fiscal policy under the new PM positively impacting stocks. Takaichi's accommodative policies helped sustain equity valuations even as BOJ tightening loomed. Support was also provided by US Fed monetary easing and a further recovery within the global economy driven by fiscal policies from major trading partners. Improvements in corporate governance have also spurred robust foreign inflows to Japanese stocks.

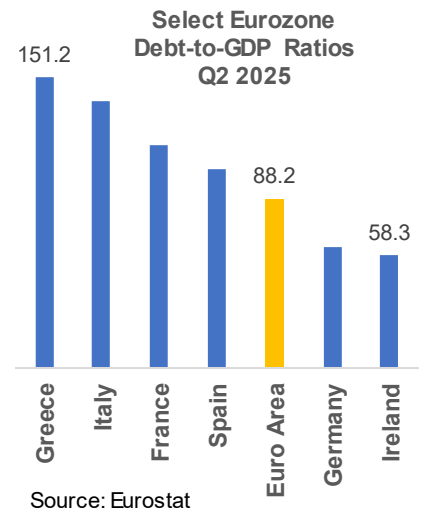
**Europe**  
European market performance was solid, keeping pace with other developed markets in Q4. The European Central Bank successfully engineered a soft landing with inflation set to close 2025 near its 2% target after peaking above 10% in late 2022. The labor market remained resilient, with the unemployment rate at 6.4%, the lowest sustained level since 1999. The ECB halted its easing cycle, leaving the deposit facility rate unchanged at 2%, down from its peak of 4% in 2024. It is



expected to remain at the current level throughout 2026. GDP growth is projected to close the year at 1.3% and remain consistent with that level in 2026 with core inflation falling below 2% next year.

The Conference Board forecasts a rebound in growth in the Eurozone for 2027 driven by falling inflation, improved financing conditions, and supportive labor markets. Consumer and business sentiment is seen as improving across the continent. The Conference Board notes that medium-term risks exist with demographic decline, geopolitical fragmentation, and policy uncertainty from elections as possible impediments to growth.

The MSCI Germany Index rose 2.5% in Q4 and was up over 36% for the year. Germany is expected to run annual budget deficits close to 4% of GDP over the next decade, increasing its debt-to-GDP ratio by 20-30%. However, Germany continues to show strong fundamentals with a current debt ratio of 65% and a track record of fiscal prudence. The DAX rose throughout the quarter, finishing at a near record high of 24,340, up around 23%. The rise has been fueled by strength in the semiconductor sector with AI chip and data center demand increasing. Defense names such as Rheinmetall and Hensoldt were among the top performers in 2025 driven by EU fiscal stimulus and energy transition spending. A more stable ECB outlook and improving macro sentiment supported financial sector performance.

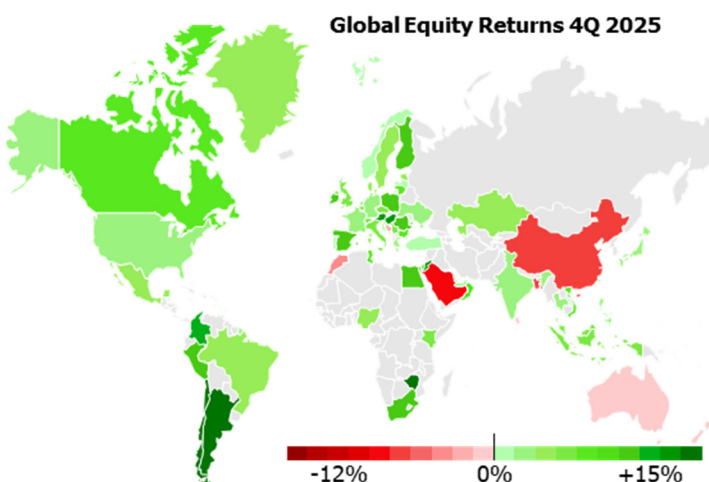


Unlike Germany, investors have become concerned about France's debt trajectory given projected budget deficits of 5-6% of GDP over the next few years along with a debt-to-GDP ratio of 110%. There has been little political appetite to reduce spending. The MSCI France Index was up 3.1% in Q4 and 28.4% for the year. Luxury sector strength drove performance as LVMH and L'Oreal were among gaining stocks to end the year. Defensive names and utilities also provided market support. However, geopolitical developments affected defense stocks with Safran and Thales weakening after comments from President Trump suggesting progress toward a Ukrainian peace deal.

## Americas

The MSCI Canada Index rose 8.1% in Q4, propelled by a commodity surge with gold, copper, and oil & gas all rising sharply. The commodity bull market combined with Bank of Canada interest rate cuts to boost Canadian equities to all-time highs. The Bank of Canada lowered its key rate 25 bps to 2.25% at the end of October to stimulate the economy, but paused in December. As rates became less restrictive, net interest margins, credit quality and loan growth served as a tailwind for the financial sector.

Latin American equities performed strongly in 2025 with the MSCI EM Latin America Index rising 8.2% in Q4 and 54.8% for the year. Rising copper and gold prices due to a weaker US dollar drove the materials (metals & mining) sector in Q4. The energy sector (oil & gas) rose as oil prices firmed in Q4 on rising global demand. Financials rallied as LatAm moved deeper into a monetary easing regime, improving profits in the sector. Real wage growth remained uneven despite easing inflation, putting pressure on the consumer sectors. Utilities underperformed as investors rotated out of defensive positions into higher beta, commodity-levered sectors.



The MSCI Brazil Index gained 5.7% in Q4 driven by a combination of global commodity strength and a weaker US dollar. Materials, financials, and energy companies lifted performance. Brazil's central bank did not lower the Selic rate in Q4, but held it steady at 15% due to lingering inflation concerns and signs of an economic slowdown. GDP growth fell 0.2% in October, below forecasts, with only the agriculture sector showing strength early in the quarter.

Elsewhere in Latin America, the MSCI Mexico Index returned 4.8%, supported by metals & mining, airlines and financials names tied to US trade. The Mexican central bank cut its policy rate to 7%, and dollar weakness boosted appetite for Mexican equities. The MSCI Argentina market rose 65% as falling inflation, fiscal policy reforms and a \$20bb US swap line drove a strong rally. Colombia, Chile and Peru posted double-digit gains in the quarter.

## Focus On: Lazy Underweights

Not to discourage any New Year’s resolutions, but most new gym memberships get canceled within six months. Failure is common because of simple, avoidable mistakes and, most often, premature quitting when results are not immediate. A study of 30 coed novice weightlifters found that, left on their own, none were lifting weights heavy enough “to induce hypertrophic responses and subsequent strength increases” [Glass & Stanton].

However, the most persistent struggles arise not from what we are doing incorrectly, but from what we are not paying attention to at all. The instinctual response to failure is to blame parts of the process already in focus. It can be difficult to recognize that the real problem lies elsewhere. For example, novice lifters who train with sufficient intensity often fail to consume enough protein to support muscle repair and growth. And even when progress is made, many fall prey to “mirror-muscle syndrome,” where muscle groups that do not show up in a casual mirror pose remain out of sight and out of mind.

It is a fair assumption that the portfolio managers in charge of your investment funds are human too, and subject to the same tendency to satisfice rather than optimize. PMs naturally concentrate on what is in their portfolio more than what is absent. At best, this feeds the most relevant information into the decision-making process. At worst, it breeds overconfidence that what has been screened out or ignored is unimportant; and, this is a fault, as lately, that markets often punish.

### Lonely at the Top...

For more than a decade, US large-cap equities have been dominated by a small group of tech-forward juggernauts. Since roughly 2013, positioning in these names has largely dictated which portfolios outperform and which lag. The labels have evolved from FANG and its variants to today’s “Magnificent Seven,” but the structural reality remains unchanged. A handful of companies represent a very large share of the most common US equity benchmark, accounting for roughly one-third of the S&P 500 and more than one-fifth of global equity market capitalization.

While this concentration can be mistaken as a recent anomaly due to the magnitude, it is a recurring feature of equity markets. A 2018 paper “Do Stocks Outperform Treasury Bills?” examined lifetime returns of US equities since 1926 and found that the entire net wealth creation of the US stock market over nearly a century was attributable to just 4 percent of listed companies. The remaining 96% of stocks collectively matched T-bill returns.

Stock returns are not normally distributed. They are positively skewed, with a small number of extreme winners dominating aggregate outcomes. The penalty for omission is asymmetric. Missing the small subset of companies that carry market returns during periods of narrow leadership can handicap a portfolio in ways that selection among the remaining majority may be unable to offset.

Concentration of Top 10 Largest Stocks			
Year	Era / Theme	Example Companies	% Glb Wgt
2025	AI & Mega-Cap Tech	Nvidia, Apple, Microsoft, Amazon, Alphabet	~25%
2000	Dot-Com Bubble	Microsoft, Cisco, GE, Intel, NTT Docomo	~17%
1989	Japan Asset Bubble	NTT, Ind. Bank of Japan, Sumitomo Bank	~13%
1972	Nifty Fifty	IBM, AT&T, Kodak, Polaroid	~18%
1964	Original Mag 7	AT&T, GM, IBM, Standard Oil, GE	~20%

While a 25% concentration is high for the 10 largest stocks in the world, global equities have been arguably more concentration at previous points. During the Japan Asset Bubble, Japanese stocks represented 45% of global market cap. In the first half of the 19<sup>th</sup> century, US equities were almost entirely banks and insurance companies. By 1900, US railroad stocks represented 63% of US market cap. The cost of a poorly managed underweight (owning less than the index) that rises alongside market concentration can quickly transform from a minor oversight to a primary driver of underperformance.

### ...and at the Bottom

Since 2020, US small-cap managers have faced their own set of market concentration challenges. Leadership has often been narrow and episodic, initially driven by meme stocks and later by speculative enthusiasm around broader themes. Many active managers dismissed the “meme-stock” phenomenon as irrational excess built on momentum rather than fundamentals. In most cases, they were directionally correct, but many underestimated how long prices could remain elevated and how often mean reversion failed to arrive on a useful timeline. In some cases, meme stocks exited indices altogether before prices returned to earth, cementing relative underperformance for managers who held zero weights.

By 2025, narrow leadership in small caps had broadened into something more complex. Meme stocks still appeared episodically, but a wider speculative wave emerged around investment “themes.” Themes differ from traditional sector classifications. They cut across industries and regions and often reflect structural narratives such as artificial intelligence, quantum computing, nuclear power, or cryptocurrency. A theme like AI can simultaneously lift semiconductor manufacturers, utilities supplying incremental power demand, and real estate companies operating data centers. But, unlike sectors, regions, and industries, themes aren’t neatly packed into off-the-shelf portfolio risk analysis software.

Standard sector-based risk decompositions can understate these cross-sector correlations during thematic regimes. When a manager ignores a theme because it does not fit neatly within their sector framework, they are not merely missing a stock. They are missing a structural shift in how risks and returns are being generated. This can be easily dismissed by managers who rely on consistent track records of profitability and mean reversion to long-term multiples.

Meme stocks present a volatile and distinct challenge, but are seen as a gamble by many investors. Unlike themes, they lack a coherent investment thesis or valuation anchor. Prices are driven primarily by social sentiment and momentum rather than cash flows. This can be summed up as a lack of the quality factor. However, so can novel themes such as quantum computing, next-gen/AI power, or (as of 1998) the internet. Memes and themes can blur together, and it seems as though some small cap managers have grown too dismissive of any sky-rocketing stock that screens poorly on quality.

### Asymmetry of Stock Picking

In a conventional stock picking process, research resources are overwhelmingly allocated to the visible portfolio. Portfolio managers assign coverage, debate position sizing, and scrutinize incremental changes among owned names. This allocation of attention creates asymmetry between how risk is perceived and how it is realized. A finite number of foreseeable risks get measured, while innumerable unforeseen risks go untallied.

However, when relative performance versus a benchmark index defines risk, then there are only a finite number of foreseeable risks. These are defined as relative security weights, and also summarized as relative weights by sector, region, etc. If the benchmark defines neutral risk, a 5 percent underweight contributes the same amount of relative risk as a 5 percent overweight. Yet managers rarely devote comparable time or rigor to the benchmark constituents they do not own.

This imbalance is rooted in a psychological phenomenon known as omission bias. Research by Ilana Ritov and Jonathan Baron shows that individuals tend to judge harmful actions, such as buying a stock that later declines, as worse than equally harmful inactions, such as failing to buy a stock that later rises. The pain of a bad decision on an owned position is immediate and personal, while the pain of a missed opportunity is diffuse and easily rationalized. An error of omission, such as not owning a few benchmark winners, is more easily attributed to style headwinds or pockets of overvaluation.

It would be impractical for US small cap managers whose benchmark includes 2,000 names to perform as comprehensive an analysis as possible on each stock. Hierarchy is necessary and owned names should receive heightened attention. Yet, thematic evaluation then becomes a critical skill for both identifying new ideas and for risk management.

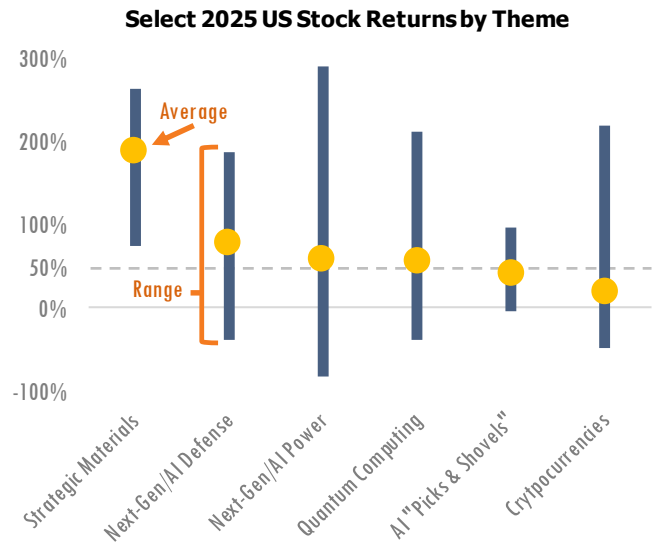
### Arithmetic of Neglect

Fundamental bottom-up managers often operate with a binary framework. They either own a stock or ignore it entirely. This is both a practical feature and a philosophical underpinning of many fundamental processes. Quantitative strategies rarely operate this way, and this difference had consequences in 2025. Over three-quarters of fundamental managers underperformed (by ~6% on average), while most quant small cap funds outperformed. Under the Fundamental Law of Active Management, performance is a function of skill and breadth, defined as the number of independent investment decisions. Ignoring large parts of the index voluntarily reduces breadth and concentrates risk, even when skill is present.

Non-zero underweights serve a critical function. Holding 2 percent of a 4 percent benchmark constituent is an explicit negative bet that reduces tracking error while preserving exposure to extreme outcomes. Many fundamental managers understand this arithmetic but remain reluctant to own names they do not actively cover or fundamentally endorse. The result is often an unmanaged zero weight rather than a controlled underweight.

### The 'No' Bias

This asymmetry of diligence often manifests as a "No" bias. A single negative opinion or a marginal screen result can be sufficient to exclude a stock permanently from consideration. Over time, familiarity replaces analysis. Names that are not owned or on a watchlist effectively cease to exist. Research budgets follow this familiarity, reinforcing a feedback loop in which only known names are studied and unknown names remain unexamined.



Some exclusions are structural. Certain managers systematically avoid BDCs, REITs, or SPACs due to governance or capital structure considerations. While philosophically consistent, these exclusions create a structural mismatch when performance is measured against a standard benchmark rather than a bespoke one. When a manager mentally substitutes a narrower benchmark for the actual yardstick used by clients, they implicitly accept unmanaged risk.

### Echoes of 1999: Memes, Themes, and Breadth

To address the omission bias, we must distinguish between two distinct types of zero-weight positions: a "strategic zero" and a "lazy zero." A strategic zero is a calculated decision where a manager analyzes a company and actively decides it is unattractive. A lazy zero is when a manager ignores a name because it falls outside their "traditional" coverage.

The danger of a lazy zero is well-illustrated by the Dot-Com Bubble. In the late 1990s, fund managers who ignored the internet theme due to traditional valuation metrics that appeared irrationally inflated missed era-defining returns. Yet, indiscriminately owning the theme proved disastrous, especially for latecomers. The managers best positioned for long-term success engaged early, selectively, and identified durable compounders like Amazon while avoiding many inevitable failures. The same challenge applies today to themes such as artificial intelligence and to episodic meme-stock dynamics.

The lesson from 1999 and other eras, is that you cannot afford to ignore some themes. What starts off as a strategic zero to a small index position or theme can grow into an alarming lazy zero weight. Investors should be wary when a lazy zero arises simply because an unfamiliar name falls outside established analyst coverage or fails to pass a cursory screen. Further, they should hold serious concern when lazy zeroes exist across sizable themes or other large idiosyncratic risks.

### A Fiduciary's Lens

For plan fiduciaries charged with selecting and monitoring investment managers, a key challenge in active fund selection is distinguishing favorable outcomes resulting from disciplined processes versus a confluence of luck. Recent returns offer limited insight. Fiduciaries can screen for strong historical returns net of fees, and most do because no litmus test exists for genuine alpha. However, this data has little predictive power in any environment, even less upon entering a new era.

Considering the danger of lazy underweights will help fiduciaries improve due diligence by keying in on evidence of institutionalized curiosity. Over time, investment teams naturally converge on a stable list of favored names. Disciplined managers counteract this entropy through formal mechanisms that force periodic re-examination of exclusions. This may include structured "devil's advocate" reviews or required re-underwriting of large benchmark constituents that remain unowned.

The portfolio construction process can be informative. Managers who view their benchmark index as a risk constraint are more likely to use non-zero underweights as deliberate tools. They recognize that managing omission risk is as important as identifying winners. A lazy zero is often justified with vague references to valuation or a lack of focus. A strategic zero is accompanied by a current model, a defined thesis, and a clear explanation of why the stock's risk-adjusted return does not compete with existing holdings. In effect, the zero weight is treated as an active risk rather than a passive omission.

While every fund requires its own tailored due diligence, fiduciaries should be alert to the following red flags:

- **Missing coverage:** No active research exists for some large benchmark constituents or themes
- **Binary positioning:** Nearly all underweight positions are zero weights
- **Stale exclusions:** Significant groups of stocks are carved out from ownership without recent justification
- **Resource imbalance:** Research is devoted almost exclusively on owned names
- **Unexplained drift:** Tracking error spikes significantly during periods of narrow market leadership
- **Lack of challenge:** No formal process exists to force a revisit/challenge to long-standing zero-weight positions

As always, a prudent fiduciary will consider a mosaic of data in seeking to confirm or dismiss the qualitative story that compels investing in a particular fund, with a particular team. A durable investment strategy, much like a healthy body, depends as much on unseen maintenance as on visible exertion. High-conviction stock selection may build the muscle behind the portfolio, but comprehensive risk management provides the nutrition that sustains long-term results. Ignoring lazy underweights starves the portfolio of diversification and resilience.

